

STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

Illinois American Water Company)	
Proposed Increase in Water and)	
Sewer Rates)	Docket No. 09-0319
)	

INITIAL BRIEF OF
THE PEOPLE OF THE STATE OF ILLINOIS

The People of the State of Illinois

By LISA MADIGAN, Attorney General

Susan L. Satter
Senior Assistant Attorney General
Public Utilities Bureau
100 West Randolph Street, Floor 11
Chicago, Illinois 60601
Telephone: (312) 814-1104
Fax: (312) 814-3212
Email: ssatter@atg.state.il.us

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I. Introduction and Summary

The People of the State of Illinois, by LISA MADIGAN, Attorney General of the State of Illinois (“the People” or “AG”), pursuant to the Illinois Administrative Code Part 200.800, 83 Ill. Admin. Code 200.800, submit this Initial Brief in response to Illinois American Water Company’s (IAWC) request for a \$58,626,634 or 28.84% overall increase in revenues from its water and sewer customers in Illinois. Sch. A-2. For many residential customers, the increases in IAWC charges will be substantial. IAWC Exhibit 9.09 shows that residential consumers using 7 ccf (which is equivalent to 5,200 gallons, and is the state average usage, Tr. 108) will see the charges they pay to IAWC, excluding purchased water in the Chicago area and excluding public fire protection charges, increase as follows:

District	1 ccf (=748 gallons)	7 ccf (=5,200 gallons)
Chicago Moreland	54.6%	49.2%
Chicago Well	54.2%	49.6%
Chicago Lake	53.1%	46.8%
South Beloit	71.0%	41.2%
Pekin	36.7%	28.2%
Zone 1	31.6%	29.3%
Sterling	33.5%	26.3%
Lincoln	34.9%	36.4%
Champaign	38.5%	34.7%

After its initial filing and upon review of its future test year, despite decreases in some costs, IAWC *increased* its overall claimed revenue deficiency to \$60,519,567 in supplemental testimony. Sch. A-2 Second Revised (filed on e-docket September 22, 2009). For the reasons stated below, it is crucial that the Commission take a close look at the costs IAWC includes in its 2010 future test year, and critically assess whether the costs and cost increases in the test year are reasonable and prudent. Analyses in this docket demonstrate that significant portions of IAWC's claimed costs are excessive and imprudent and substantial adjustments must be made. As a

result, its claimed revenue deficiency is significantly overstated.

A. This Docket Is The Third In A Series Of Rate Increase Requests That Have Resulted In Rates That The Public Sees As Excessive and Out-of-Control.

This docket is the latest in a series of rate cases in which IAWC has requested substantial increases in revenue from consumers. The following table demonstrates the distribution of the increases across IAWC's districts, including the increase requested in this docket. Due to rate design and cost allocation considerations, the rate increases for individual customers and customer classes vary.

District	Proposed 2009 Increase Sch. A-3 * From IAWC 9.09 residential 7 ccf	2008 Revenue Increase From Appendices to Order in Docket 07-0507	2003 Increase From Appendices to Order in Docket 02-0690
Southern Districts – Zone 1	<i>30.08%</i>	<i>14.90%</i>	<i>13.51%</i>
Chicago Metro Water	<i>25.54%</i>	<i>5.28%</i>	<i>44.19</i>
Chicago Metro Sewer – Collection Collection and Treatment	<i>0 24.29%</i>	<i>-15.58%</i>	<i>33.98</i>
Pekin	<i>30.9%</i>	<i>21.21%</i>	<i>2.90%</i>
Lincoln	<i>35.58%</i>	<i>-.76%</i>	<i>13.68%</i>
Champaign	<i>34.7% (now Zone 1)*</i>	<i>47.2%</i>	<i>15.70%</i>
Sterling	<i>26.3% (now Zone 1)*</i>	<i>20.76%</i>	<i>51.15%</i>

Consumer dissatisfaction and anger at the continuing pace of water (and sewer) price increases were evident in the outpouring of consumer comment and participation in public meetings requested by consumers to discuss IAWC's rates that occurred throughout the state.

See 220 ILCS 5/8-306(n).¹ Three public hearings were held in the Chicago region alone (Mt.

¹ Section 8-306 was added to the Public Utilities Act in 2006 and provides: (n) Rate increases; public forums. When any public utility providing water or sewer service proposes a general rate increase, in addition to other notice requirements, the water or sewer public utility must notify its customers of their right to request a public forum. A customer or group of customers must make written request to the Commission for a public forum and must also provide written notification of the request to the customer's municipal or, for unincorporated areas, township government. The Commission, at its discretion, may schedule the public forum. If it is determined that public

Prospect, Homer Glen, Wheaton), a hearing was held in Springfield (where customers from the Champaign district appeared), and hearings were held in Alton, which is part of Zone 1. In all, 95 consumers and 22 public officials spoke on the record, and many more were present.

Some representative comments are the following:

Randy Kemper, Alton Public Hearing, a customer of Fosterburg Water Company that buys water from IAWC in Zone 1 said: “We are talking about a rate increase of 30 percent every three years. Where is that going? That's going beyond anything that anybody increases in their home, in their own budget...And I just see the excess.” Tr. at 38 (Nov. 9, 2009, transcript filed November 24, 2009). In Springfield, James Faron said: Last year ... actually, in '08, it [price increase] was 35 percent. This year it's now 47 percent. What business would ever attempt to do that? Other thoughts that came as a private business person -- mismanagement and poor planning.” Tr. At 26 (October 1, 2009, transcript filed October 16, 2009). Nancy Dietrich, a Champaign consumer said: “Now, I can't imagine what would happen if a government entity decided to raise its rates on anything by 81 percent, and if this company can't pay for a water treatment plant and cover its expenses with the increase from last year, I think it has a serious problem. Aren't businesses supposed to be more efficient than this?” Id. at 24.

In the Public Forums across the state, consumers expressed frustration that their bills are two to three times higher than in neighboring communities. Mt. Prospect Public Forum at 24, 36, 42, 54, 57 (Oct. 8, 2009); Wheaton Public Forum at 54-55 (Nov. 4, 2009); Homer Glen Forum at 105, 116 (Oct. 19, 2009); Springfield Public Forum at 31. They also commented on the high fixed charges, how they cannot “conserve their way to a lower bill” and monthly bills that exceed

forums are required for multiple municipalities or townships, the Commission shall schedule these public forums, in locations within approximately 45 minutes drive time of the municipalities or townships for which the public forums have been scheduled. The public utility must provide advance notice of 30 days for each public forum to the governing bodies of those units of local government affected by the increase. The day of each public forum shall be selected so as to encourage the greatest public participation. Each public forum will begin at 7:00 p.m. Reports and comments made during or as a result of each public forum must be made available to the hearing officials and reviewed when drafting a recommended or tentative decision, finding or order pursuant to Section 10-111 of this Act.

\$60 for as little as 2,000 gallons. Mt. Prospect Public Forum at 22, (Oct. 8, 2009); Wheaton Public Forum at 29, 36, 61, 64 (Nov. 4, 2009). Lax maintenance practices and poor water quality were also mentioned by more than one participant. Mt. Prospect Public Forum at 29 (Oct. 8, 2009); Wheaton Public Forum at 43, 48, 70 (Nov. 4, 2009); Alton Public Forum at 37 (Nov. 9, 2009). Perhaps the most compelling comments were those of a young mother who recently moved to the Mount Prospect area. At the October 8, 2009 meeting she stood up at the very end of the meeting and said:

My name is Elizabeth Bialobrzewski, B-i-a-l-o-b-r-z-e-w-s-k-i. –
I'm a fairly new resident. I wasn't really prepared to speak today, but I want to say that I'm really happy that a lot of the residents here came today and have stated great cases and have done more research than I have.

But what I do want to state is that I'm very upset about how much you have to pay for water here. I lived in Niles and I lived in Chicago and now I live in Mount Prospect. And I would never have moved here if I knew how much more we were paying than my friend who moved to Mount Prospect and gets water from the Village. Period. I have a family. I have a new daughter. I was excited to come here, to live here, to be a citizen here. And -- I'm sorry -- we can barely make ends meet. I work a full-time job. My husband works a full-time job. We made sure to come here tonight to at least see and hear what's going on. And something has to be done.

I'm stuck. What am I going to do? I just bought a house. So I have to pay this. And you know, I made a mistake, I guess. Mount Prospect is here for families? How? I'm standing right here in front of you fairly young and I'm telling you it's hard. Thank you.

Tr. at 61 (October 8, 2009); See also Tr. At 52 (“my neighbor has lost two opportunities to sell his house because prospective buyers are not willing to pay what he pays for water.”). See also HG Ex. 2.0 at 4 (“unreasonably high water and sewer rates will drive builders and homeowners away from Homer Glen.”).

The Commission's public comment line is another reflection of the widespread public outrage at the size of IAWC's current rates and its proposed increases. Despite the fact that IAWC only has 308,000 customers (IAWC Ex. 2.0 Revised at 2)² and is a relatively small utility

² See IAWC Ex. 2.01 for the number of customers, the volumes of water sold and other information for each IAWC district.

by Illinois standards, the public comment page contained 567 comments³ as of January 7, 2010.

By contrast, the Peoples Gas/North Shore rate case, affecting three to four times as many customers, has attracted only 139 comments. Dockets 09-0166/0167. The fact that so many members of the public have taken the time to attend public meetings, and call-in or write a Public Comment about IAWC's increase request should be taken as a strong signal that IAWC's repeated rate increase requests have become excessive. The public is relying on the Commission more than ever to reign in the excessive spending that underlies this Company's rate request.

Another indication of public dissatisfaction with IAWC's repeated increases is the number of individuals and municipalities that have intervened in this docket. The following cities or villages have intervened and/or submitted testimony:

City of Champaign	City of Des Plaines	City of Elmhurst
City of Peoria	City of Pekin	City of Urbana
Village of Bolingbrook	Village of Glen Ellyn	Village of Homer Glen
Village of Lemont	Village of Lombard	Village of Mount Prospect
Village of Orland Hills	Village of Prairie Grove	Village of Savoy
Village of St. Joseph	Village of Sidney	Village of Tinley Park
Village of Woodridge		

Glen Ellyn consumers Melody Fliss, Rosmary Katona, Harold Menger, Eileen Nelson, and Tim Nelson all intervened.

Eleven municipalities co-sponsored the accounting testimony of Ralph C. Smith with the People of the State of Illinois. Tr. at 510 (Dec. 10, 2009). Consumers Robert Boros and Avis Gibbons of Mount Prospect prepared direct and supplemental testimony submitted by the People of the State of Illinois. The City of Des Plaines filed the testimony of City Manager Jason Bajor

³ A small number of comments address the pending Ameren rate increase, but the vast majority are correctly directed at IAWC.

and Assistant Direct of Public Works and Engineer Jon Duddles. DP Ex. 1 and 2. Mayor Irvana K. Wilks of the Village of Mount Prospect filed Direct Testimony, MP Ex. 1.0; the Village of Homer Glen, which has about 6,000 homes served by IAWC, filed the testimony of its Mayor Jim Daley, HG Ex. 1.0 (page 4); City Manager Mary Niemec, HG Ex. 2.0; Fire Chief Michael Schofield, HG Ex. 3.0; and engineer Aaron Fundich. HG Ex. 4.0. This unprecedented participation should focus the Commission's attention on the imprudent, unreasonable or unsupported expenses that must be excluded from rates to minimize the impact of this rate increase request.

B. Consumer and Municipal Dissatisfaction Is Rooted In Repeated Rate Increases and Unreasonably High Rates Relative To Surrounding Water and Sewer Rates.

In addition to the participation in Public Meetings and on the Commission's Public Comment system, testimony was submitted by consumers and municipalities addressing IAWC's already excessively high water and sewer prices. In the Chicago Metro District, representatives of Mount Prospect, Des Plaines, and Homer Glen submitted testimony describing the large disparities between IAWC rates and the water rates paid by consumers in their towns or neighboring towns who receive water from the municipalites rather than from IAWC.

Mount Prospect Mayor Irvana K. Wilks, who serves on the Northwest Joint Action Water Agency Board, testified that Mount Prospect has both a Village-owned water system and the Illinois American Water system within its boundaries. She has “the unique perspective and ability to compare the two systems and their impacts to our residents.” MP Ex. 1.0 at 2. She expressed concern about the negative impact IAWC's “significant increase in rates” will have on the 22% of its residents and the 16% of its commercial and multi-family buildings that are served by IAW. She testified that she “is concerned about the enormous disparity IAW's proposed increase would create between what residents and businesses pay for Village owned water versus what others pay for IAW water.” Id. at 3. Mayor Wilks noted that IAWC's proposal would

increase the bill of a family that uses 10,000 gallons of water from \$46.85 to \$67.48, not including purchased water costs. She testified that her Village charges \$4.68 per 1,000 gallons with no additional charges. If the proposed rate increase is allowed, IAWC customers would pay 44% more than Village water customers. MP Ex. 1.0 at 4. Mayor Wilks also expressed concern about how the economic downturn has affected Mount Prospect residents, and stated that it “would be very irresponsible and inconsiderate in light of the nation's current economic condition” to impose “such a tremendous rate increase, one that is so disparate among residents and businesses in different areas of town.” Id.

The City of Des Plaines also submitted testimony addressing the problems created where some residents receive city water at reasonable rates, while other residents pay the substantially higher IAWC rates. City manager Jason Bajor expressed concern about IAWC's significant increase and the “increased burden on residents who are already struggling to make ends meet.” DP Ex. 1.0 at 2, 4. Mr. Bajor testified that if the rate increase request is approved, “residents within Des Plaines that were in [IAWC]'s service area would pay more than triple of what other Des Plaines residents pay for the same water.” Id. at 3. Mr. Bajor described the efforts Des Plaines is making to minimize the burden on residents despite its loss of revenue due to the recession and the increased burdens borne by the city as a result of foreclosures, bankruptcies, and job losses among its residents. He said:

In order to make up for the 2009 revenue shortfalls, the City has drastically reduced its operating budget by delaying capital improvements such as the construction of new fire and police stations and delaying the purchase of vehicles equipment and other supplies. Top level management received no salary increases. In addition, in 2008 the City cut expenditures, and laid off 12 City employees. These measures were taken so that the burden placed on the City's taxpayers to balance the budget through the annual property tax levy was kept below 4%. The City is faced with the same bleak revenue projections for 2010, will again keep the annual property tax levy at or near 4%, and will in all likelihood be forced to lay off several employees to balance the 2010 budget. In spite of the above, the City was still able to maintain its water system and make needed improvements, and has included necessary maintenance and improvements to the water system in the 2010 budget.”

DP Ex. 1.0 at 4-5. In light of its efforts to keep costs and taxes low, Des Plaines was “shocked and disheartened” to see that IAWC has hired several new employees and has proposed an aggressive capital improvements program, “all during a time of continued record unemployment, and increased foreclosures and bankruptcies.” Id. at 5. Mr. Bajor concluded that the Commission should “require Illinois American Water to exercise the same restraints on increased spending as the City of Des Plaines and every other City and Village in their service area” by cutting unnecessary administrative costs, non-essential capital projects, restricting new hiring, and limiting wage and salary increases. Id. at 5-6.

Des Plaines Assistant Director of Public Works Jon Duddles testified that the City had to make significant cutbacks in its workforce, but that it maintained the same level of water service to its residents. He was not aware of any such efforts in IAWC's Waycinden service areas. DP Ex. 2. See also HG Ex. 1.0, 2.0, and 3.0, discussed in the Initial Brief of the Village of Homer Glen.

In addition to testifying at public meetings and posting comments on the Commission's Public Comment system, two Mount Prospect residents offered testimony in this docket. After hearing about the rate increase, Ms. Avis Gibbons attended an open house sponsored by IAWC on June 15, 2009. AG Ex. 3.0 at 4. After the open house, she put together letters to Chairman Box and the other Commissioners to voice her concerns about IAWC's rates and poor maintenance record and collected 154 signatures from 131 households. The petitions and signatures are attached to her testimony as AG Ex. 3.3. Ms. Gibbons testified that several of her neighbors “recalled their shock upon receiving a bill from IAW and finding it to be three times higher than their former communities ([Niles, Skokie and Chicago] for the same service and usage.” AG Ex. 3.0 at 7. Her neighbors also complained about frequent rate increases and poor service. Id.

Mr. Robert Boros, also a Mount Prospect resident, also circulated the petition among his neighbors opposing IAWC's rate increase request. He spoke to each person who signed the

letter, and collected 57 signatures, which are attached to his testimony as AG Ex. 4.2. AG Ex. 4.0 at 3-4. Mr. Boros paid \$63.38 for water service, fire protection, and sewage collection, based on his July, 2009 IAWC bill.⁴ AG Ex. 4.0 at 3. If he were to pay for the same 4,000 gallons of water and sewage collection from the following towns, his water and sewer collection bill would be:

Arlington Hts	\$17.44
Niles	\$18.36
Mount Prospect (village water)	\$24.76
Morton Grove.	\$24.64
Park Ridge	\$30.76
IAWC	\$63.38 (AG Ex. 4.1).

See AG Ex. 4.0 at 4. Like Ms. Gibons, Mr. Boros found that his water bill was often higher than his gas and his electric bill. Between 2004 and 2008, his annual water bill was \$995, compared to his average annual electric bill of \$738; and in 2009 his water bills were higher than his electric bills (\$528.54 for water compared to \$490.02 for electricity) and within two dollars of his gas bill, which was \$542.38. AG Ex. 4.0 at 4-5. See also AG Ex. 3.0 at 4 (in May, 2009 Ms. Gibon's IAWC bill exceeded both her electric and her gas bill).

AG Cross Exhibit 3 is a copy of a flyer IAWC distributed to IAWC customers as part of its communications plan. According to IAWC President Karla Teasley, the flyer was meant to “communicate with and educate our customers on the things that are either impacting them or plan to impact them, and rates certainly is one of those things.” Tr. at 177 (Dec. 8, 2009). AG Cross Exhibit 3 announces to consumers: “**High quality**, reliable water and wastewater service for around a **penny a gallon.**” (bold in original). This equals \$10.00 per 1,000 gallons. Ten dollars per 1,000 for water and wastewater services is considerably higher than the rates described by Mr. Boros in AG Exhibit 4.0 at 4 and by witnesses for Homer Glen. HG Ex. 2 at 4-

⁴ Mr. Boros submitted Supplemental Testimony that the purchased water charge on his bill increased from \$1.67 to \$2.23 per thousand gallons in October, after his Direct Testimony was filed. This increases his bill further, and unrelated to IAWC’s request in this docket. AG Ex. 8.0.

6; HG Ex. 4 at 9-11. Unfortunately, however, it is considerably lower than the price per gallon Mr., Boros actually paid per month from January, 2008 through August, 2009. On page 6 of AG Exhibit 4.0, Mr. Boros calculated the total cost per 1,000 gallons for each month. He *never* paid less than \$10.00 per 1,000 gallons, and paid between \$12.15 and 15.85 per 1,000 gallons in 13 of the reported 20 months. Three months he paid less than those amounts (\$11.16, \$10.42, and \$11.37), and four months he paid more (\$19.55, \$47.67, \$19.55, \$19.24). AG Ex. 4.0 at 6-7.

If IAWC is granted the entire rate increase it is requesting, some customers will pay \$17.00 per gallon for water and wastewater collection services, while other customers who receive water and wastewater collection and treatment will pay \$26.00 per gallon, according to materials prepared by IAWC and used at public meetings in the Chicago Metro area. AG Cross Ex.4 and 5; Tr. 179 and 181. IAWC's Chicago Metro rates are already higher than the rates of neighboring communities and already higher than the penny-a-gallon touted by IAWC's promotional materials. The rate increase requested in this case, if allowed, will burden consumers who already pay more than is typical in their areas even more.

Ms. Gibons noted that because IAWC consumers cannot take their business elsewhere, they rely on the Commission to “support, assist and protect us.” AG Ex. 3.0 at 8. Water is not only a monopoly service, but an essential service. Further, Ms. Gibons testified that high water costs have far-reaching consequences that can affect public health, businesses and economic development, and quality of life. AG Ex. 3.0 at 8-9. High water charges transfer money and resources out of the community, and burden consumers who may be on fixed incomes, may be facing unemployment, or may otherwise be facing economic challenges.

C. The Unprecedented Public Interest In this Docket Combined With The Repeated, Substantial Increases IAWC Has Obtained In The Past Few Years Should Lead The Commission To Carefully Review IAWC's Claimed Costs and Exclude Imprudent and Unreasonable Costs From IAWC's Rate Increase Request.

The parties to this docket have identified several costs that IAWC has misstated,

overstated, or that simply have increased by excessive amounts over the past few years.

Although the following does not include all of the issues raised in this Docket, they are examples of the unreasonable costs that IAWC seeks to charge consumers:

1. By understating its use of short term debt, IAWC has overstated its costs by between \$2.2 and \$3.023 million. AG/JM Ex. 5.0 at 14-15.
2. IAWC claims an excessive cost of equity of 10.9%, rather than the 7.40% recommended by CUB witness Christopher Thomas, which is more consistent with the current decline in returns generally available in the capital markets. CUB Ex. 1 and 2.
3. The management services (or “business support services”) expense IAWC seeks to charge consumers has continued an excessive and unreasonable climb. In Docket 07-0507 that cost increased 170% and in this filing, based on a test year a mere six months after the test year in Docket 07-0507, the management fee expense has increased another 22.5%. AG/JM Ex. 5.0 at 49. This increase comes when inflation has been negligible, and is on top of an increase in the number of direct IAWC employees and in its salary and benefits expenses. See AG/JM Ex. 5.0 at 30-32 & IAWC Sch. C-11.2a, C-11.2b, C-11.3, Sch. G-10 (showing a 9.17% increase in salary expense from December 2008 to the 2010 test year). This unchecked growth in management services, even while direct IAWC employment expenses increase, indicates a company with unreasonable, excessive layers of management. The Commission should find this increase in management costs unacceptable.
4. IAWC also seeks to charge consumers an unreasonable amount for seeking this rate increase as well as to reach back in time and charge consumers for IAWC’s failure to live within its budget for its last rate case. The 43%

increase in legal expenses, combined with an outrageously expensive, \$422,900 Service Company Study, cannot be considered reasonable by any objective standard. See AG/JM Ex. 5.0 at 38-39. The Commission must take a close look at these rate case expenses pursuant to Section 9-229 of the Public Utilities Act, and disallow the incredible increases and unreasonable charges that IAWC seeks to include in rates.

5. IAWC's cash working capital calculation unfairly and improperly charges consumers for prepayments to its affiliated management services company and for a purported revenue lag that assumes that consumers, on average are not paying by their bill's due date. AG/JM Ex. 5.0 at 19-27.
6. In response to the concern repeated by consumers at public meetings and on the Commission's Public Comment site, the Commission should limit the fixed customer charge to only those costs that are truly customer related, and reject the Company's attempt to increase the residential customer charge by 32.6% to 56.4%. AG Ex. 2.0 at 5. Increases of this magnitude discourage conservation and make it harder for consumers to control their bills through conservation.

IAWC is a monopoly provider of water and sewer services. In exchange for its certificate of public convenience and necessity, IAWC is subject to Commission review, and its rates must be “fair, just, and reasonable.” 220 ILCS 5/9-101. In reviewing the substantial increases requested in this docket, the Commission should be mindful of the public's reliance on the Commission's duty to weed out unreasonable and imprudent practices and cost increases. As one Champaign consumer stated at the public meeting in Springfield: “I'm just asking the ICC to restore the people's faith in the Illinois Commerce Commission, hold to your mission and vote against this increase.” Nancy Dietrich, Springfield meeting, p. 25.

II. IAWC's Rate Base Should Be Reduced as Recommended By AG/Joint Municipalities Witness Ralph Smith To Include A \$4.7 Million Adjustment To Cash Working Capital and To Remove Costs Associated With A Corporate Study Of Business Processes.

AG/Joint Municipalities witness Ralph C. Smith agreed with all of the Staff rate base adjustments shown on AG/JM Exhibit 5.1, Schedule B, lines 2 through 8, as well as with the Company's response to them. See *id.* at lines 9 through 15. However, Mr. Smith made an additional recommendation to remove \$4,757,000 from cash working capital to remove the effect of IAWC's use of an inappropriate revenue collection lag and its attempt to recover from ratepayers additional funds to pay itself for pre-payment of its substantial Service Company charges. The calculation of his adjustment to cash working capital is found at AG/JM Exhibit 5.1, Schedule B-1. Both of Mr. Smith's proposed adjustments to cash working capital should be adopted by the Commission to protect ratepayers from paying the Company a return on a distorted cash working capital amount.

A. Cash Working Capital – Revenue Collection Lag

The Commission should adjust IAWC's calculation of the revenue collection lag in its lead-lag study to remove the improper assumption that the Company, *on average*, receives payment from consumers several days after the due date on the bill. This component of the lead-lag study is distorted because IAWC used 2005 data that is outdated and does not reflect improved collections and because IAWC failed to remove the effect of uncollectibles, which by definition have an unusually long collection lag. AG/JM Ex. 5.0 at 19-21. In addition, IAWC failed to differentiate the collection lag among various customer groups, effectively charging residential customers for the payment lag of a few large users. IAWC Ex. 6.00 SR at 11.

The Company used a revenue collection lag of 24.09 to 30.62 days, which effectively assumes that customers on average pay their bills late. AG/JM Ex. 5.0 at 21. Under the Commission's Rule 280.90, residential customers have 21 days to pay a bill from the utility and

commercial customers have 14 days from the mailing date. 83 Ill. Adm. Code 280.90. The Company's cash working capital calculation effectively asks consumers to pay carrying costs for a revenue collection lag that assumes that, on average, customers pay late. That is unfair to consumers and does not accurately reflect when payments are actually made.

The Company argues that its calculation does not imply that customers "on average" pay their bills late. IAWC Ex. 6.00 SR at 15-16. However, the effect of the Company's approach is that customers pay the cost for cash working capital as if, on average, customers pay their bills late. The fact that some customers drive up the collection lag, particularly given Company witness Kerckhove's testimony that a few relatively large customers are responsible for a "significant portion" of outstanding accounts (IAWC Ex. 6.00 SR at 11), makes it more unfair that *all* customers must pay increased rates as a result of an inflated revenue collection lag calculation. AG/JM witness Smith provided the revenue collection lag for each district, which more fairly calculates and allocates the revenue collection lag. AG/JM Ex. 5.0 at 22.

AG/JM witness Smith also pointed out that the Company used 2005 data in its lead-lag study. Although Company witness Kerckhove defends the use of old information as a cost savings mechanism (IAWC Ex. 6.00 SR at 18), in 2005 there were substantial billing problems, which became the subject of a complaint against IAWC by the People of the State of Illinois and the Village of Homer Glen. In Docket 05-0681/06-0094/06-0095 the Commission addressed improper back-billing by IAWC that resulted from its meter replacement program in the Chicago Metro District. Docket 05-0681/06-0094/06-0095, Order at 22-27 (April 18, 2007). The Commission also addressed customer service deficiencies that made it difficult and time-consuming for customers to have billing disputes resolved. *Id.* at 38-39. The Commission should reject the use of 2005 data in light of these documented billing problems which resulted in customers paying less than the billed amount while disputes related to the meter exchange were investigated.

The revenue collection lag calculated by the Company also overstates the collection lag by failing to make an adjustment to remove the effect of uncollectibles. Although the Company agrees that uncollectibles should be excluded from the calculation of cash working capital, subtracting the amount of uncollectibles from revenue in the lead lag study is only part of the needed adjustment; the other part of the needed adjustment, which AG-JM witness Smith and IWCC witness Gorman have both identified and discussed, is to correct the collection lag itself to reflect a collection lag period that is no longer than the payment due date.

B. The Commission Should Reject IAWC's Attempt To Increase Rate Base To Compensate It For Payments To Its Affiliated Service Company.

As discussed in more detail below at pages 20ff, IAWC seeks to recover from ratepayers a substantial management or business support services fee⁵ that it pays to its affiliate, the American Water Works Service Company (the "Service Company"). IAWC claims that it pays this fee monthly based on its agreement with the Service Company, which the Commission approved. IAWC Ex. 6.00 R2 at 9. The agreement that IAWC relies upon, however, does not mandate prepayment. Rather, it states that the Service Company shall render a bill "as soon as practicable after the last day of each month... for all amounts due from Water Company for services and expenses for such month plus an amount equal to the estimated cost of such services and expenses for the current month." *Id.* This language does not require prepayment.

The language quoted from the Service Company Agreement allows the Service Company to bill IAWC for "the estimated cost of such services and expenses for the current month." This is a far cry from mandating pre-payment. It implies that the Service Company may bill some amounts at the end of the month and other expenses at the beginning of the "current month," without specifying which services can be billed "for the current month" or specifying the time for payment. IAWC's decision to pay its affiliated company in advance is not required by the

⁵ IAWC has asked the Commission to approve \$21,167,057 (excluding incentive compensation) for the Service Company. AG/JM Ex. 5.0 at 49.

agreement the Commission approved between IAWC and the Service Company.

As AG/JM witness Smith noted in his Rebuttal Testimony at pages 23-24, the West Virginia Public Service Commission recently addressed an identical argument by West Virginia American Water Company. It adopted the argument of the state Consumer Advocate Division (CAD) to apply IAWC's 12 day lag for direct payroll to its Service Company payments, and refused to allow the utility to include a payment lag in cash working capital for pre-payment to the affiliated Service Company. The West Virginia PSC stated:

The Commission is not persuaded that the CAD recommendation is unreasonable or requires actions on the part of the Company that violate its agreement with AWWSC. The agreement allows AWWSC to provide a current bill 'as soon as practicable' after the last day of each month. It also provides that AWWSC provide an estimate of the bill for the next month. However, there is no provision for advance payments of the next monthly bill. While WVAWC should not act unreasonably in making payments to AWWSC, a lag comparable with its own payroll lags does not appear to be unreasonable, while an advance payment does appear to be unreasonable. The Commission will adopt this CAD adjustment to the Cash Working Capital.

AG/JM Ex. 5.0 at 24, quoting Case No. 08-0900-W-42, Order at 35-36 (March 25, 2009)(available at: <http://www.psc.state.wv.us/orders/default.htm> - search March, 2009).

AG/JM witness Smith recommended that the same adjustment be made in this case. He applied the same 12 day payroll lag as a reasonable payment lag for payments to IAWC's affiliated Service Company. The Commission should modify the Company's lead lag study to reflect this more reasonable and fair payment lag and to avoid requiring ratepayers to first pre-pay IAWC's affiliate and then pay a return on the cash used to pre-pay the affiliate.

C. The Commission Should Remove \$625,000 From Rate Base For A Corporate Study Of Business Practices.

In its direct case, IAWC included in rate base a corporate study of business practices in both 2009 and 2010. In AG/JM Exhibit 1.0 at pages 22-25, the double count was identified, and the Company removed the double count. However, it left in rate base \$625,240 for Illinois's share of a study conducted by its parent company, American Water Works Corporation to

“assess the needs of our business, to satisfy customer and other stakeholders expectations, and to review different technology options to support the implementation of automated processes that provide improved service to our customers.” IAWC Ex. 5.00 R2 at 6. The questions before the Commission are: (1) is it appropriate to spend money on a study of this kind when consumers are seeing repeated, double-digit increases in their bills and many are facing unemployment and recession and (2) are IAWC’s customers being asked to shoulder an excessive portion of a study that appears to duplicate the services that are supposed to be provided by the Service Company.

Many of the local government officials and consumers who have participated in this docket by submitting testimony, speaking at public meetings, circulating petitions, and writing public comments on the Commission’s web site have noted that difficult economic conditions facing Illinois (and the nation) and the efforts being taken by local governments (e.g., DP Ex. 1, DP Ex. 2, and HG Ex. 1.0) to control costs. By contrast, IAWC’s testimony in this docket is more about justifying increased costs rather than explaining how costs are being reduced or controlled.

The “Comprehensive Planning Study” that IAWC would like to include in rate base is an example of the kind of expenditure that should not be included in a rate increase request as large as the one sought in this docket. The kinds of review to be done by the report, as described by IAWC witness Edward Grubb at IAWC Exhibit 5.00 R2 at 6, appear to duplicate the services provided by the Service Company and for which IAWC seeks more than \$20 million. IAWC witness John Young discusses these services at length in IAWC Ex. 12.00, and identifies the following 10 areas where the Service Company purportedly offers expert, management services: Communications and External Affairs, Corporate Finance, Customer Service Center, Divisional Operations Support and Regulated Operations, Human Resources, Information Technology Services, Legal, Operations Services Department, Shared Service Center, and Other Services. Yet, despite all of this expertise and service allegedly available through the Service Company,

IAWC is asking consumers to fund a separate, third party study of the same business practices that the Service Company is supposed to provide.

This is the kind of “extra” management review that ratepayers should not be expected to fund when they are already paying among the highest rates in the state, and often live side-by-side with consumers who pay one third to one half what they pay for water and/or wastewater services. IAWC should be trying to keep costs down – not spending more than half a million dollars on a study to tell them how to run their business. The Commission should remove \$625,000 for the Comprehensive Planning Study from rate base.

In addition, IAWC has not adequately justified paying \$625,000 for its share of this American Water Works study. In response to AG data request 9.16, excerpts of which were admitted as AG Cross Exhibit 21, IAWC was asked for the total cost of the study. In response, IAWC only included the amount IAWC was including in rate base, preventing parties from determining whether the allocation to Illinois was fair. In addition, IAWC provided copies of the contracts with vendors who were doing the study. A list of their charges is included in AG Cross Exhibit 21.

The total charges included in the contracts produced by IAWC for the American Water Works study was \$2,239,000. AG Cross Ex. 21. Illinois ratepayers are being asked to pay \$625,240 of that amount, or 27.9%. However, IAWC only serves about 9% of all American Water Works customers. Tr. at 473 (Dec. 9, 2009). Mr. Grubb testified that he believed that IAWC represented more than 9% of American Water’s regulated customers, suggesting that IAWC customers “could be 15, 16 percent.” Id. at 474. Irrespective of whether IAWC customers represent 9% or 16% of American Water’s total customers, IAWC has not justified allocating 27.9% of the Comprehensive Planning Study costs to Illinois. In addition to the imprudence of spending millions of dollars on management consultants when rates are already

too high and consumers are facing substantial increases, the absence of a justification for the allocation of \$625,240 to Illinois requires that this cost be removed from rate base.

D. Conclusion

The Commission should adopt the adjustments to IAWC's cash working capital recommended by AG/JM witness Ralph Smith and reduce rate base by \$4.757 million and remove \$625,240 from rate base for the unjustified and imprudent Comprehensive Planning Study.

III. IAWC's Operating Income Should Be Increased by No Less Than \$3,979,000.

Several of the operating income adjustments proposed by AG/Joint Municipalities witness Ralph C. Smith and the Staff were adopted by the Company and are uncontested. Those adjustments are shown on AG/JM Exhibit 5.1, Schedule C, lines 2 through 14, and include Interest Synchronization (which is dependent on rate base), Depreciation Expense, Deferred Charges, Advertising Expense, Lobbying Expense, Insurance Expense, Depreciation Expense, Tank Painting Expense, General Inflation Expense, and Chemical Expense. Mr. Smith made additional recommendations that cumulatively result in an additional \$3,476,000 in operating income.

The People recommend additional adjustments to address: (A) Management Services or Service Company fees; (B) Removal of the Non-labor General Inflation Adjustment; (C) Insurance Expense; (D) Prior and Current Rate Case Expenses; and (E) Large Industrial Volumes in Zone 1.

A. The Commission Should Reject The 22.5% Increase In Management Fees In Less Than 12 Months.

IAWC has asked the Commission to include in rates \$21,167,057 (excluding incentive compensation) that it claims it will pay to its affiliated Service Company in the 2010 test year.

This amount is 22.5% more than the \$17.251 million (excluding incentive compensation) it was allowed to include in rates for the test year ending June 30, 2009 in IAWC last rate case, Docket 07-0507. AG/JM Ex. 5.0 at 49. In Docket 07-0507 the management fee expense increased \$11,681,000 or about 170%, from the \$6,843,000 IAWC recovered in management fees in its prior rate case. ICC Docket 07-0507, Order at 28 (July 30, 2008); ICC Docket 02-0690, Order at 26 (allowed management fee of \$6,843,000). These huge cost increases cover management services that are not provided by IAWC personnel who actually operate the utility on a day-to-day basis. Tr. at 95 (Dec. 9, 2009).

1. The Commission Should Not Allow IAWC To Recover Expenses for Both An Increased Number of IAWC Employees And An Increased Management Fee Expense.

In its last rate case, the Commission accepted IAWC's argument that the huge increase in management fees was justified by "an organizational restructuring in 2004 that ultimately eliminated 31 positions from the payroll of IAWC." Docket 07-0507, Order at 30 (July 30, 2008). However in this docket, not even two years later, IAWC's payroll shows a consistent increase since February, 2007, after which the actual number of employees rose from 435 to 486 in December, 2008, IAWC Sch. C-11.2a, and the number of authorized employees rose from 446 to 473. IAWC Sch. C-11.2b. In the 2010 test year IAWC is asking the Commission to further increase the number of IAWC direct employees to 510. Tr. at 75-76, 78-79. In addition, the payroll expense and the costs of employee benefits are also increasing. IAWC Sch. C-11.3 and G-10.⁶ Unlike the situation in Docket 07-0507 where there was a decrease in IAWC employees, in this docket IAWC claims both an increase in direct employees and a 22.5% increase in the Service Company expense. It does not appear that Service Company employees are replacing IAWC employees or are performing work otherwise performed by IAWC employees.

⁶ IAWC Schedule G-1 shows the following payroll expenses: actual 2007: \$21,420,971 actual 2008: \$22,736,589
Test year 2010: 24,821,998

In testimony, IAWC witnesses produced extensive lists of services provided by the Service Company. The lists include “Communications and External Affairs, Corporate Finance, Customer Service, Divisional Operations Support and Regulated Operations, Human Resources, Information Technology Services, Legal, Operations Services and Shared Services. The Service Company also operates facilities for water quality analyses in Belleville, Illinois.” IAWC Ex. 1.0 at 8; See also IAWC Ex. 12.00. IAWC direct employees, however, handle the actual operation of the utility. IAWC President Karla Teasley testified that:

Illinois-American Water employees are directly involved in the day-to-day operations ... they provide support in the distribution operations area, in the production area. They are in the field providing day-to-day contact and service to customers every day. ... the people that run the plants, the people that fix the main breaks, the people that read the meters, the people that provide, you know, some maintenance to the facilities, all of the kind of hands-on day-to-day work that we do to keep the water flowing is provided by Illinois-American Water employees.

Tr. at 95-96. Ms. Teasley also testified that there are IAWC employees who are responsible for engineering, planning, design, overseeing construction projects and overseeing the capital program, as well as finance and communications and external affairs. Tr. at 96-97. Yet, IAWC seeks to include in rates more than \$20 million for its Service Company to provide management and business services.

The Commission approved the substantial increase in Service Company costs in IAWC’s last rate case because it believed that there were reductions in IAWC’s labor costs that justified the higher Service Company charges. Docket 07-0507, Order at 30 (July 30, 2008). However, in this docket there is an increase in IAWC employees, who are involved in day-to-day operations, customer service, maintenance, and planning for IAWC. Further, IAWC removed several functions from the Service Company. IAWC Ex. 6.00 Supp. At 9. As IAWC witness Rich Kerckhove testified: The Service Company expense would have been higher except for amounts for customer accounting and miscellaneous expenses are now accounted for under those

expenses that were previously budgeted as service company fees. Tr. at 435 (Dec. 9, 2009). Although Mr. Kerckhove could not say how much was removed from the Service Company expense and transferred to these accounts, his exhibit 6.02 Supp. shows that as of the filing of IAWC Exhibit 6.00 Supp. IAWC added \$821,952 to Customer Accounting and \$22,717 to Miscellaneous. If these expenses had not been moved from the Service Company charge, the \$544,823 Supplemental increase to the Service Company expense would have been \$1,389,492.

IAWC has not justified increasing the expense for Service Company services by more than 20% over its expense in its last rate case. IAWC has hired more direct employees, which should cut down on the need for Service Company support, and IAWC has transferred expenses from the Service Company account to other accounts. These actions should have lead to a lower – not a higher – Service Company expense. The increase in this expense requested by IAWC should be rejected.

2. The Excessive and Repeated Increases In The Service Company Expense Demonstrate That IAWC and The Service Company Have Failed To Exercise Fiscal Discipline.

IAWC President Teasley testified that IAWC controls costs through careful budgeting, and that the Company monitors costs “monthly and continuously.” IAWC Ex. 1.0 at 21; Tr. at 119 (Dec. 9, 2009). Notwithstanding this purported monitoring, however, IAWC is requesting a substantial increase that dwarfs the increases (and one decrease) in the budgeted and actual Service Company costs from 2007, 2008, 2009 and the 2010 test year. For example, the following table, taken from IAWC Schedule G-1, shows the actual, the plan (or budgeted), and the June 30, 2009 and the December 31, 2010 test year level of Management Fees, also known as Service Company or Business Support Services:

Table 1 - Service Company Costs

	Actual	Change from Prior Year	Plan (or Budget)	Change from Prior Year
Dec. 2007	20,093,161		19,278,490	
Dec. 2008	20,248,278	.77%	19,046,511	(1.2%)
Dec. 2009	n/a		20,121,164	5.6%
Test Yr - Dec. 2010 IAWC Sch. G-5 First Revised, p. 8	n/a		22,560,025	12.1%
Test Yr – June 2009 Order at 30, Docket 07- 0507 (July 30, 2008)			18,523,751	21.79%

As this table shows, the increase in IAWC's actual management fees expense from 2007 to 2008 was quite small, and the budgeted amount for 2008 actually decreased. The increase in the plan or budget expense 2008 through 2009 was 5.6%, while the increase from 2007 to 2009 was only 4.37%. Tr. at 123 (Dec. 9, 2009). However, the for 2010 test year, IAWC first budgeted a 9.4% increase from 2009, and a few months later increased its budgeted cost by \$544,000, raising the amount requested in rates to 12.1% over the budgeted 2009 amount. See Id. at 123-128. The ultimate increase claimed in the test year is exorbitant compared to the increases/decreases of the prior years, and are even worse when compared to the June 30, 2009 test year amount in Docket 07-0507. When incentive compensation is removed from the June 30, 2009 and the December 31, 2010 test years, the increase from the last case is 22.5%. AG/JM Ex. 5.0 at 49.

The test year increases, which are so much higher than the Company's actual and planned increases in prior years, coupled with the increase in IAWC employees, demonstrate that IAWC has not been able to realize savings or economies from the use of the Service Company. In IAWC's last rate case the Commission cautioned IAWC that:

If IAWC plans to continue to utilize the Service Company because doing so arguably benefits ratepayers by reducing IAWC's labor and other related costs, then at some point the lower costs must be more evident. ¶ Based on the evidence, the Commission adopts the management expense as recommended by IAWC. The Commission, however, has a continuing obligation to ensure just and reasonable rates.

Docket 07-0507, Order at 30 (July 30, 2008).

In order to ensure just and reasonable rates, the Commission should deny IAWC any increase in the test year Service Company expense. The test year in the last rate case ended June 30, 2009 and the test year in this case runs from January 1, 2010 to December 31, 2010.

Although the Company has identified categories of services that are provided by the Service Company (such as customer service, legal, corporate finance), it has not explained why the cost for these services has increased 22.5% compared to the last test year, and has failed to show that this increase is prudent, reasonable, or necessary. This huge increase is particularly troubling in light of both the burden consumers are facing due to high unemployment, foreclosures, and the recession; the efforts local governments have made to keep costs low such as layoffs and salary freezes; and the much lower 4.37% increase for the same services between December 2007 and December 2009. A Service Company expense of \$17,251,000 (rather than the \$21,136,000 requested by the Company) would increase IAWC's operating income by \$3,885,000. See AG/JM Ex. 1.0 at 48.

In the alternative, if the Commission will not maintain the Service Company charge at the level allowed in Docket 07-0507, AG/JM witness Ralph Smith recommended that the Service Company expense be increased by no more than 5% over the \$17.251 million test year expense in Docket 07-0507, resulting in an adjustment of \$3.022 million to the Service Company expense. AG/JM Ex. 5.0 at 50. This adjustment removes incentive compensation from both the June 30, 2009 test year and the December 31, 2010 test year, and is consistent with the growth of this expense reported in IAWC Schedule G-1 and in Table 1 above.

3. Other States Have Been Troubled By The Increase In Management Fees Claimed By AWWC's Regulated Operating Companies.

The Service Company that IAWC pays the Service Company (or Management or Business Support Services) fee also provides services to other states. Tr. at 367 (Dec. 9, 2009).

In a recent California-American water rate case, the California Division of Ratepayer Advocate recommended and the California PUC allowed substantial reductions in California-American's Service Company and General Office expenses. The ALJ took administrative notice of the California Public Utilities Commission's decisions in regard to California American Water Company, and the decisions were filed on e-docket on December 10, 2009 as IAWC-AG Admin. Notice Doc 1. In the California PUC's Final Decision No. 09-07-021, the Commission referred to being "[c]onfronted with 'seemingly endless' increases in administrative costs," and noted that in Cal-Am's last rate case, the CPUC approved a settlement that included an audit of Cal-Am by the Division of Ratepayer Advocate (DRA). IAWC –AG Admin. Notice Doc 1 (Part 1) at 94, 95. The CPUC noted that the DRA made 14 specific proposals to Cal-Am's General Office charge and adopted \$3.2 million in adjustments. *Id.* at 96. The specific adjustments, including nine that relate to the Service Company, are summarized on Appendix C to the order, which is found in IAWC-AG Admin. Notice Doc 1, Part 3. In its final order, the CPUC allowed Cal-Am to file a Petition to Modify the Order provided it "fully discloses all non-regulated operations which use any assets or employees included in revenue requirement." *Id.* at Part 1, page 156. On rehearing, more than three months after the final order was entered, Cal-Am satisfied the DRA that some of its allocations were in fact supported, and the DRA agreed to allow \$7,454,286 of Service Company allocations into rates. IAWC –AG Admin. Notice Doc 3. The other adjustments on Appendix C to the Order were not affected. IAWC-AG Admin. Notice Doc 1, Part 3.

In addition to California, the Tennessee Regulatory Authority, in reviewing a Tennessee-American Water Company docket, also confronted the problem on escalating management fees. Although it had ordered an audit of the fees, it found that the audit conducted by the Company-retained expert was not independent and "did not address the primary concerns of the Authority that the costs were the results of prudent management decisions." *In re Tennessee American*

Water Company, Docket No. 08-00039, Order at 21-22 (January 13, 2009), available at:

<http://www.state.tn.us/tra/orders/2008/0800039we.pdf> . The Tennessee Regulatory Authority

ordered Tennessee American to issue an RFP for:

“a comprehensive audit by an independent certified public accountant. The RFP for the audit shall include, but not be limited to, an investigation of AWWSC’s management performance and decisions ... and evaluate and attest to the charges allocated to TAWC, including the efficiency of processes and/or functions performed on behalf of TAWC, as well as the accuracy and reasonableness of the allocation factors utilized.”

Order at 21.

These orders, by sister PUCs, demonstrate that the problem with escalating Service Company charges is not unique to Illinois. Other states have been faced with how to respond when AWWSC affiliates seek exorbitant increases in Service Company fees, and both California and Tennessee ordered that an *independent* audit of those fees and services take place. Although the Commission in IAWC’s last rate case did order a study of Service Company costs, the study produced (like in Tennessee) was not independent and does not provide the Commission or the public with any ways to restrain the growth of these charges. In addition to disallowing Service Company charge increases, which provides the appropriate incentive to IAWC to control that cost, the Commission may wish to order that an *independent* audit of AWWSC fees to IAWC be conducted, under the direction of the Commission Staff or the Office of the Attorney General.

3. The Record Shows Poor Service Company Services and Unwarranted Costs.

In response to an AG data request, IAWC identified several instances where IAWC challenged Service Company charges and/or practices. As these examples show, the layers of management provided by the Service Company can add unwarranted costs and complexity to address a specific problem. Four examples are:

AG Cross Exhibits 8 and 9: Service Company engineering did not keep IAWC apprised of plans for Illinois plant. IAWC Director of Engineering Jeffrey Kaiser contacted the Service

Company on June 3, 2008, shortly after he was hired by IAWC⁷ because neither he nor the Illinois head of production were informed of an RFP for an Illinois project. The response, almost two months later (July 29, 2008) finally provides a draft scope of work for Illinois review, and schedules a meeting for the end of August for Service Company people to come to Illinois. As shown in AG Cross Exhibit 9, Mr. Kaiser appropriately objected to paying for travel for six Service Company people to spend four days in Illinois, and the number of Service Company representatives was cut to “three or four at the most.”

AG Cross Exhibit 10: The Service Company charged fees to a closed Champaign District project. It was unclear why the charges were posted to the closed project. The e-mail says that “they are not Illinois engineers, and do not report to anyone in our office. ... Of the eight names, Brent O’Neil did not even recognize at least three of them.”

AG Cross Exhibit 12: In July, 2008, Cheryl Norton, hired by IAWC on December 31, 2007,⁸ expressed concern that a project that had been ordered more than 14 months earlier was “very complex” and “very costly.” She noted that IAWC personnel “had not participated in creating the business requirements” and that the scope of the project was much larger than Illinois needed. Ms. Norton had to protest the allocation of costs to Illinois, saying:

I don’t have a problem paying for Illinois’ portion of this, however, there was a substantial amount of time spent creating this for the enterprise and then removing those references. I find it very difficult absorbing the entire amount when this project never should have been so unrealistic. We depend on your department to be the experts and create workable solutions for our regulatory requirements. The original project was so far out of scope that it never should have been developed or considered.”

Email of October 21, 2008 8:04 am.

Customer Service Outages, Summer 2008: Ms. Norton also complained to the Service Company about problems with the customer service function. She testified that there were at least two telephone service outages in the summer of 2008, during which customers could not get

⁷ Mr. Kaiser was hired as Director of Engineering for IAWC in April, 2008. IAWC Ex. 3.00 at 2.

⁸ Ms. Norton was hired as IAWC Vice President of Operations effective December 31, 2007. IAWC Ex. 2.0 at 1.

through to the Company's customer service line. Tr. at 246. She was moved to send an email saying that "this seems to be happening more and more frequently. That may not be the case, but I know it has happened numerous times in the past few months." Tr. at 248. Notwithstanding these problems, IAWC was not given a credit or rebate from the Service Company as compensation for the poor service. Tr. at 247.

These examples show that the Commission cannot allow IAWC to include an inflated Service Company expense in rates. Close review to protect consumers from inappropriate services and costs, and limiting the amount that can be included in rates will provide IAWC with the appropriate incentive to keep these costs from spiraling out of control. The Commission and IAWC should heed the statement by the Hewitt U.S. Salary Increase Survey, Survey Findings: 2009 and 2010 at page vii: "2010 will not be a year with loose purse strings." AG/JM Ex. 5.0 at 50.

4. The Lack of Allocation of Management Fees To The Chicago Waste Water District Calls Into Question The Accuracy of The Management Fee and Its Allocation.

In reviewing the Service Company charges, AG/JM witness Ralph Smith noted that there was no allocation of these charges to the Chicago Wastewater District. AG/JM Ex. 1.0 at 50. Neither IAWC President Karla Teasley nor Paul Herbert, who prepared the cost of service studies, was able to explain the absence of an allocation. Although Ms. Teasley testified that wastewater customers receive service company services and "benefit from the same types of services that our water customers receive," Tr. at 130 (Dec. 9, 2009), she was not able to answer why there was no allocation of those costs to the wastewater district. Id. at 132-133. Although Ms. Teasley later attempted to suggest that applying Service Company costs to wastewater would somehow result in "double-counting" for customers who take both water and wastewater services, Tr. at 175-175, that argument should be discounted in light of her statements on pages 130-132 about the use of the Service Company services for wastewater customer service, billing,

IT, and planning. In connection with planning, Ms. Teasley testified that “some of the greatest challenges” are in the wastewater area. Id. at 131. See also Id. at 289-290 (Herbert: “I can’t offer anymore explanation than what she gave.”)

The lack of allocation to wastewater calls into question the accuracy of the Service Company allocations in general. Clearly there are services that wastewater customers require that are provided through the Service Company, but those costs are not being correctly allocated to that district. In light of IAWC’s extraordinarily high wastewater treatment costs (see page 54 below), one may suspect that this lack of allocation was done to try to limit the size of those costs, albeit to the detriment of water customers.

5. Conclusion

For the foregoing reasons, the Commission should not increase the Service Company expense at all from that allowed in Docket 07-0507. There have been increases in costs that the Service Company allegedly previously replaced (i.e. labor expense) and costs that had been in the Service Company expense have been removed. Yet, the test year expense is increased by double digits. The Commission should find this cost increase imprudent and unreasonable and reject it.

B. The Deflation for 2009 Requires That The Company’s Non-labor Inflation Adjustment Be Removed.

The Company has increased its non-labor Operations and Maintenance expenses by an inflation rate of 2.5%, which the Commission should remove, given the recent deflation reported by the United States Bureau of Labor Statistics. AG Cross Exhibit 16, an excerpt from the Bureau of Labor Statistics dated November 18, 2009, shows that inflation for the twelve months ending October 2009 was a *negative* .2%. This is consistent with the Livingston Survey submitted as IAWC Exhibit 6.02 R2 that showed that the 2008 to 2009 estimates of both the Consumer Price Index and the Producer Price Index are both negative, showing deflation.

AG/JM Ex. 5.0 at 31. As Mr. Smith pointed out, “To the extent that IAWC relied upon any positive estimate of generalized inflation from 2008 to 2009 in developing its 2009 expenses, to which IAWC seeks to apply an additional inflation factor for 2010, these prior assumptions of 2009 inflation were wrong ... (the most current information shows price index *decreases* for 2009 on both a CPI and PPI basis). *Id.* at 31-32. Mr. Smith removed \$244,000 to reverse IAWC’s non-labor inflation adjustment. AG/JM Ex. 5.1, Sch. C-2.

In Surrebuttal, IAWC witness Kerckhove suggested that the Livingston Survey should be disregarded because it is based on a “forecasted inflation rate.” IAWC Ex. 6.00 SR at 26. Although he suggested that the CPI reported by the Bureau of Labor Statistics for the ten months ended October 31, 2009 was 2.3%, in fact, AG Cross Exhibit 16 shows that the Bureau of Labor Statistics reported that unadjusted inflation for the 12 months ended October 2009 for “all items” was *negative* .2. Mr. Kerckhove’s suggestion that the Livingston estimate of deflation is irrelevant in light of actual inflation (or deflation) reports mistakenly finds inflation where deflation was reported.

Mr. Smith did not recommend that IAWC’s non-labor expenses be reduced to reflect deflation. However, he did point out that it is inappropriate and unfair to ratepayers to inflate non-labor expenses when there is effectively no inflation in the economy. The Commission should remove the inflation factor from IAWC’s expenses.

C. The Commission should reject IAWC's Belated Attempt to Increase Its Insurance Expense

In his review of IAWC's filing, AG/JM witness Ralph Smith noticed that IAWC had included an increase to its insurance expense for a “Retrospective Adjustment” or “Retrospective Accrual.” This \$212,660 expense was not included on IAWC Schedule C-17 First Revised for 2007, 200 or 2009; was not in IAWC's original filing; was not addressed by IAWC in its Direct, Supplemental, or Rebuttal-1 or Rebuttal-2 testimony; and was not in IAWC's last rate case

(Docket 07-0507). AG/JM Ex. 5.0 at 45. This adjustment would increase the Insurance Other Than Group (IOTG) expense to \$3,721,452. AG/JM Ex. 5.01, Sch. C-5.

IAWC's attempt to increase its insurance expense to account for the Retrospective Accrual is unreasonable and should be rejected by the Commission. IAWC's actual expense for IOTG has been notably under-budget for each of the years 2007 and 2008 and IAWC has received refunds from its insurers for those years. AG/JM Ex. 5.0 at 46. For 2007 the insurance over-payment was \$2.3 million and in 2008 IAWC's over-projection for IOTG was \$.9 million. Id. At 47. In addition to these over-payments, American Water Works Service Company received a retrospective return on its premium in 2008 and in 2007 it received a cumulative refund for the years 1975-2006. In all, IAWC received insurance refunds totaling \$411,900. Id. at 48.

In light of the consistent over-budgeting of its insurance expense and the sizable refunds IAWC and its affiliates have received over the past few years, it is unreasonable for IAWC to attempt to increase its insurance expense by \$213,000 by adding a "Retrospective Accrual" adjustment. The Commission should remove the \$213,000 expense as shown on AG/JM Exhibit 5.1, Schedule C-5.

D. The Commission Should Reject IAWC's Request to Recover and Supplement Its Prior Rate Case Expense As Unlawful.

This is the second IAWC rate case in less than two years. Docket 07-0507 was filed on October 11, 2007 and this case was filed on May 29, 2009. In each case IAWC asked for a rate case expense that significantly exceeded the rate case expense in its last case, as the following shows:

Year/Docket Number	Total Rate Case Expense	
02-0690	\$ 668,831	Allowed
07-0507	\$1,482,020	Allowed
09-0319	\$2,339,496	Requested

AG Cross Ex. 19; IAWC Sch. C-10.1. In both dockets 02-0690 and 07-0507 the Commission allowed IAWC to recover the entire amount of rate case expense requested.

In 2008 the General Assembly added Section 9-229 to the Public Utilities Act. PA 96-33. That section directs the Commission to “specifically assess the justness and reasonableness of any amount expended by a public utility to compensate attorneys or technical experts to prepare and litigate a general rate case filing. The issue shall be expressly addressed in the Commission's final order.” 220 ILCS 5/9-229. Given the sizable increases evident over the past few years, and the significant jump in rate case expense from the last rate, the Commission must examine the details of the claimed rate case expense under Section 9-229 and exclude expenses that it finds higher than a just and reasonable level.

1. IAWC's Request to Increase The Prior Rate Case Expense Is Unjust and Unreasonable and Violates the Rule Against Retroactive Ratemaking.

In its last rate case, IAWC was allowed to recover \$1,482,020 as a rate case expense, which was the full amount it requested. AG Cross Ex. 19. The Docket 07-0507 the rate case expense was 2.2 times higher than the rate case expense in IAWC prior rate case (Docket 02-0690). The 2007 rate case expense included legal fees and expenses that were 81.6% higher than the prior case, revenue requirements that were 75.1% higher, the CPA review (59.1% lower), rate of return consultant at a cost that was 21.2% higher, a demand study, a municipal rate study, “other” that increased from \$10,032 to \$200,000, and a depreciation study. *Id.*⁹ Despite being

⁹ AG Cross Ex. 19 is IAWC's Schedule C-10.1 from Docket 07-0507, available on the Commission's e-docket system. The percent indicated on the far right column does not represent the increases from Docket 02-0690 to Docket 07-0507. It is not clear what the percent (inc/decr) column measures.

allowed to recover the full amount requested (notwithstanding the substantial increases it represented), IAWC now asks the Commission to increase its 2007 rate case expense by \$187,047 for the Municipal Rate Study – an amount that dwarfs the \$37,000 original cost requested in 2007 and increases the total expense by 12.6%. The Commission should find that attempting to increase the cost for a study by a factor of five is *per se* unreasonable.

In addition to being an outrageous increase over the allowed cost, IAWC's attempt to increase recovery for its 2007 rate case expense violates the rule against retroactive ratemaking. The Supreme Court explained retroactive ratemaking as follows:

“Once the Commission establishes rates, the Act does not permit refunds if the established rates are too high, or surcharges if the rates are too low. (*Business and Professional People I*, 136 Ill.2d [192] at 209 [1989].) This rule is consistent with the prospective nature of the Commission’s legislative function in ratemaking. In addition, this rule promotes stability in the ratemaking process. *Citizens Utilities Co. v. Illinois Commerce Commission* (1988), 124 Ill.2d 195, 207.”

BPI II, 146 Ill.2d at 243. In *BPI I*, the Court held that the rule against retroactive ratemaking prohibited the Commission from adopting an order that included “retroactive rate refunds” to Commonwealth Edison customers. 136 Ill.2d at 213; see also *id* at 205-206, 209. In *Citizens Utilities Co.* the Court held that the Commission unlawfully reduced the utility’s rate base to account for tax benefits the Company had obtained years earlier. 124 Ill.2d at 206. In *Citizens* the Court emphasized that utilities are only authorized to charge the rates approved by the Commission, and that both surcharges and refunds were prohibited to either increase rates or return funds when expenses were found to be different from what the Commission approved. 124 Ill.2d at 207.

IAWC is asking the Commission to effectively add a surcharge to rates to compensate the Company for the difference between the rate case expense level included in current rates (based on the expenses included in the test year that ended June 30, 2009), and the actual expense incurred by the Company in 2009. This adjustment effectively charges ratepayers for an expense

that exceeded that allowed by the Commission in IAWC's last rate case, while shielding shareholders from the consequence of IAWC's inaccurate projection of that cost. This kind of retroactive adjustment violates the rule against retroactive ratemaking and undermines rate stability and should be denied.

2. IAWC's Proposal To Amortize And Defer The 2007 Rate Case Expense Violates The Rule Against Single Issue Ratemaking And The Prohibition Against Retroactive Ratemaking And Should Be Rejected.

a. Rolling The 2007 Rate Case Expense Into The 2010 Test Year Is Prohibited Single Issue Ratemaking.

In IAWC's last rate case, it was allowed to recover its full rate case expense, with the cost of the depreciation and the municipal rate studies (equaling \$171,520) amortized over five years and the remainder of the expense amortized over three years. AG/JM Ex. 1.0 at 34. The Commission did not authorize IAWC to defer the unamortized portion of the rate case expense for future recovery if it filed a rate case before the end of the amortization period

Notwithstanding the lack of specific authorization to defer and amortize the rate case expense, IAWC has assumed in its filing that it is entitled to add the unrecovered balance of the 2007 rate case expense to this year's rate case expense. Adding the 2007 expense to the 2010 test year expenses, however, violates the rule against single issue ratemaking because it adds costs outside the test year from one category of expense to the 2010 test year used to set future rates. This distorts the ratemaking formula that aggregates all of the utility's costs and revenues for a test year to determine a revenue requirement, violates Illinois law, and should be rejected.

It is well established that utility rates are established on the basis of a test year. In Part 285 of the Commission's rules, a utility seeking to increase rates must present extensive data showing its costs for a 12 month period. 83 Ill. Adm. Code 285.1000 et seq. The utility has the option of choosing a future or a historical test year. 83 Ill. Adm. Code 287.20. The test year is used to accurately determine the utility's revenue requirement and to prevent a utility from

overstating its revenue requirement by mismatching low revenue data from one year with high expense data from a different year. *Business and Professional People in the Public Interest v. Illinois Commerce Commission*, 136 Ill.2d 192, 219 (1989) (“*BPI I*”); *Business and Professional People in the Public Interest v. Illinois Commerce Commission*, 146 Ill.2d 175, 238 (1991) (“*BPI II*”).

The prohibition against single issue ratemaking is related to the test year rule. As the Supreme Court explained in *BPI II*:

The rule against single-issue ratemaking recognizes that the revenue formula is designed to determine the revenue requirement based on the *aggregate* costs and demand of the utility. Therefore, it would be improper to consider changes to components of the revenue requirement in isolation. Often times a change in one item of the revenue formula is offset by a corresponding change in another component of the formula. For example, an increase in depreciation expense attributable to a new plant *may* be offset by a decrease in the cost of labor due to increased productivity, or by increased demand for electricity. ... In such a case, the revenue requirement would be overstated if rates were increased based solely on the higher depreciation expense without first considering changes to other elements of the revenue formula. Conversely the revenue requirement would be understated if rates were reduced based on the higher demand data without considering the effects of higher expenses.

Id. at 244-245 (emphasis in original).

IAWC has asked the Commission to add 2007 rate case expenses to the 2010 test year, effectively and improperly overstating the revenue requirement by importing expenses from outside the test year. Savings or changes in other aspects of IAWC’s operations during the test year or in past years could affect the overall profitability of the enterprise. Yet, the deferral and amortization that IAWC requests would isolate rate case costs so that they are recovered from future ratepayers irrespective of whether the Company’s revenues in the prior years were, in the aggregate, sufficient.

In *BPI II* the Court held that the Commission could not include deferred depreciation costs in rates without violating the test year rule and prohibition against single issue ratemaking. The Court pointed out that depreciation was an operating expense, and said: “the critical inquiry

is not how much cash was paid in a given period, but rather how much did the value of the underlying asset decline during that period.” 146 Ill.2d at 239. The test year matches operating expenses with the period of time that the expenses produce value to the consumer. As the *BPI II* Court stated: “Depreciation recognizes the cost of that portion of the asset which is expended in a given year, regardless of the time period in which the construction costs were actually paid.” *Id.* The purpose of the test year is to match the utility’s costs with the benefits produced by those costs.

Illinois law and ratemaking does not authorize a utility or the Commission to roll one expense, in this case the rate case expense, into future test years. This mismatches costs and revenues, as well as costs and the benefit produced by that cost. See *BPI II, supra*. The Commission should reject IAWC’s attempt to recover past rate case expenses in future rates as impermissible single issue ratemaking.

b. Rolling The 2007 Rate Case Expense Into The 2010 Test Year Is Prohibited Retroactive Ratemaking.

The prohibition against retroactive ratemaking, discussed above at pages 33-35, also prohibits the Commission from adding uncollected 2007 expenses to the 2010 test year. Once a revenue requirement and rates are set, the utility is given the opportunity to manage its operations within the rates set by the Commission. A utility might successfully manage its operations so that it does not need to seek additional revenue for several years while earning a reasonable return for its shareholders. On the other hand, it may be unable to manage its operations to earn a reasonable return and seek additional revenues from the public. Irrespective of how the utility fared in the prior years, when it resets its rates, the Commission only considers costs for the test year. The Commission may not reduce rates to reflect higher than authorized returns in prior years and it may not increase rates to reflect poorer performance in prior years.

See *Citizens Utilities Co. v. Illinois Commerce Commission* 124 Ill.2d 195, 207 (1988) (Commission erred by reducing utility's rates to account for prior cost reductions); *BPI II*, 146 Ill.2d at 243 (Commission may not add costs from prior years even though those costs were never included in rates).

Despite the fact that the Commission did not specifically address IAWC's rate case expense in Docket 07-0507 (other than to include it in the schedules), IAWC is treating its 2007 rate case expense as if the Commission allowed it to defer and amortize that cost. In the absence of such authorization, it is a violation of the rule against retroactive ratemaking to add costs from 2007 to 2010 expenses for purposes of setting rates. Adding costs in this way undermines Illinois regulatory policies that promote rate stability. By unilaterally including unamortized 2007 rate case expenses in the 2010 test year, the Company is effectively pancaking rate case expenses, where costs from years past accumulate year by year so that ratepayers become responsible for historical as well as current costs. The General Assembly's directive to the Commission to "specifically assess the justness and reasonableness of any amount expended by a public utility to ... litigate a general rate case filing" mandates that unauthorized deferral of this cost be denied.

The Commission should reject IAWC's assumption that it can simply add the unamortized balance of the 2007 rate case expense to the 2010 test year as a violation of both the prohibition against single issue ratemaking and the prohibition against retroactive ratemaking. In addition, sound regulatory policy allocates to utilities the responsibility for managing their operations between rate cases, and prohibits them from relying on future recovery of past costs.

c. The "Normalization" Approach Discussed By AG/JM Witness Smith Is Consistent With Illinois Law And Illinois Ratemaking Rules.

Commenting on the Commission's statement in an Ameren rate order allowing Ameren to

recover the unamortized balance of rate case expense,¹⁰ AG/JM witness Ralph Smith discusses the accounting policies and reasons for rejecting the deferral and amortization approach proposed by IAWC and using a normalization approach that establishes a “representative and normal annual level of reasonably and prudently incurred regulatory expense.” AG/JM Ex. 1.0 at 42.

Mr. Smith testified that

Although the amortization treatment afforded rate case expense previously effectively treats the rate case expense as an asset, rate case costs do not meet the criteria for a regulatory asset of volatility and materiality and should not be afforded regulatory asset treatment. The ratemaking treatment of such costs should therefore provide for a normalized expense allowance (similar to other O&M expenses), rather than the establishment of a regulatory asset that is amortized prospectively. The purpose of the rate case allowance should be to include in rates a representative and normal annual level of reasonably and prudently incurred regulatory expense, rather than to provide the utility with guaranteed dollar-for-dollar cost recovery. Consistent with such normalization treatment of this expense, IAWC should not establish an asset for deferral of the current rate case cost and should not record amortization. Once a normalization approach is adopted, any remaining amortization of prior case balances would be replaced by a new representative, normalized rate case expense in IAWC’s next rate case.

Mr. Smith further testified that a normalization approach, which is ordinarily used for operations and maintenance expenses, does not deny the utility the opportunity to recover its reasonably and prudently incurred costs. He stated:

Normalization treatment provides the utility an opportunity to recover a normalized level of reasonable and prudently incurred cost, but does not single out one item of O&M cost – rate case expense – for a special guaranteed recovery (and potential for over-recovery) that is different from other O&M expenses. Normalization treatment merely treats rate case cost similarly to other test year O&M costs which are reflected in rates based on “normal” levels found to be reasonable in a test year. O&M expenses are not normally singled out for specific deferral and recovery, and normalization treatment is deemed reasonable for ratemaking purposes. Exact dollar-for-dollar recovery of other O&M expenses that are found to be reasonable and prudently incurred in a test year is not guaranteed; however, it is generally considered that a utility, if managed prudently, has been provided with an opportunity to recover such reasonable and prudently incurred expenses. A utility’s rate case cost should be no different. As explained above, rate case cost can, and I recommend should, be treated on a normalized basis, similar to other O&M expenses that are reasonable and prudently incurred in a test year and are not singled-out for guaranteed recovery.

¹⁰ AG/JM Ex. 1.0 at 40, fn 25.

AG/JM Ex. 1.0 at 43. See also AG/JM Ex. 5.0 at 42-43 (“The purpose of the rate case allowance should be to include in rates a representative and normal annual level of reasonably and prudently incurred regulatory expense.”).

Consistent with normalization of the rate case expense, the rate case expense determined to be reasonable and prudent for the 2010 test year should be the only regulatory or rate case expense included in rates in this docket. No recovery for unamortized 2007 rate case expenses should be allowed.

d. Without Waiving The Above Arguments, If The Commission Allows Recovery Of The Unamortized 2007 Rate Case Expense, IAWC Should Not Be Allowed To Increase Costs To Consumers By Changing The Amortization Period Allowed In Docket 07-0507.

Without waiving the above arguments that recovery of the 2007 rate case expense violates the rule against single issue ratemaking, the prohibition against retroactive ratemaking, and the usual treatment of O & M expenses, AG/JM witness Smith has presented an amortization period that is fairer to consumers than the period proposed by IAWC. IAWC’s proposal to change the period of time over which to amortize the prior rate case expense will unreasonably and unnecessarily burden consumers with additional costs and should be denied. As AG/JM witness Ralph Smith demonstrated on AG/JM Exhibit 5.1, Schedule C-3, page 2, IAWC's proposal to shorten the amortization period for some expenses while extending it for others will cost ratepayers an extra \$156,215 compared to Mr. Smith's proposal to synchronize the previously approved three year amortization period with the current rate case expense, and keep the remainder of the five year amortization period for the expenses currently subject to the five year amortization.

E. The Rate Case Expense IAWC Requests For This Case Is Unreasonable and Must Be Adjusted To A Reasonable Level.

As mentioned above, last term the General Assembly amended the Public Utilities Act to

require the Commission to “specifically assess the justness and reasonableness of any amount expended by a public utility to compensate attorneys or technical experts to prepare and litigate a general rate case filing. The issue shall be expressly addresses in the Commission’s final order.” 220 ILCS 5/9-229 (effective July 1, 2009). Unfortunately, the Commission Staff accepted the Company’s invitation to ignore the substantive increases in rate case expense from the case barely two years ago, and to only consider the “actual” expenses presented by the Company for 2007 in this 2009 case. Tr. at 537 (Dec. 10, 2009). AG/JM witness Ralph Smith did look at the increases presented in this year’s rate case expense. AG/JM Ex. 1.0 at 37, 39-40; AG/JM Ex. 5.0 at 36-40. Moreover, the Commission is obligated to independently evaluate or assess the specific costs that make up the 2009 rate case expense.

At the outset, the \$2.34 million rate case expense requested by IAWC is 58% higher than the \$1.48 million 2007 rate case expense. AG/JM Ex. 5.0 at 36; AG/JM Ex. 5.1, Sch. C-4, page 1. Considering the individual components of the rate case expense, it is plain that certain costs have risen at an alarming rate, and that other costs are simply not justified by the services provided.

1. Legal Fees and Expenses

IAWC requested \$930,000 in legal fees and expenses in this docket. This represents an increase of 43% over the 2007 legal fees and expenses requested and allowed in IAWC’s last rate case (Docket 07-0507). IAWC has offered no reason for the difference between this case and its last case. Rather, it simply asserts that its attorneys are experienced and highly qualified. AG/JM Ex. 5.0 at 38.

As Mr. Smith pointed out, an increase of 43% in a single expense item is unreasonable, particularly in light of the poor economy, high unemployment, and the deflation of the past year. AG/JM Ex. 1.0 at 39. In contrast to a 43% increase in legal fees and expenses, Jason Bajor, the City Manager for the City of Des Plaines testified that his city has taken steps to control and limit

costs. He said:

due to the unfortunate state of today's economy, many Des Plaines residents are walking a very fine line with regards to paying their bills on a monthly basis. ... Job losses, foreclosures, and bankruptcies have placed additional burdens on the City, not only from revenue lost but also in additional burdens dealing with safety and maintenance issues of vacant houses abandoned by their owners. ... Top level management received no salary increases. In addition, in 2008 the City cut expenditures, and laid off 12 City employees. These measures were taken so that the burden placed on the City's taxpayers to balance the budget through annual property tax levy was kept below 4%.

DP Ex. 1 at 4-5. Rather than limiting expenses in light of the difficult economic times facing many residents, IAWC's requested a 43% increase in legal fees and expenses. This shows a disregard for economy or prudence.

Mr. Smith recommended that legal fees and expenses increase by no more than 10% over the last rate case, which would cap the legal fees and expenses at \$715,000. AG/JM Ex. 5.0 at 44. However, the Commission can also determine that *no increase* from the \$650,000 legal fees and expenses requested and allowed in the 2007 rate case is justified. The 2007 expense was more than 80% higher than the 2002 expense of \$357,876 for essentially the same work: presenting a rate increase request. Further, this case does not present new or unique legal issues, the time frame for the case is the same as all other rate cases (eleven months pursuant to Section 9-201), and evidentiary hearings only lasted three days, which is not last an unusually long time. See Transcripts for December 8, 9, and 10, 2009. At the 2002 level, legal fees and expenses equaled more than \$35,000 per month for the eleven month suspension period; at the 2007 level, legal fees and expenses equaled \$59,000 per month; increasing the 2007 level by 10% equals \$65,000 per month, and IAWC's requested amount of legal fees and costs equal \$84,500 per month for eleven months.

These are huge numbers, and the increases over prior allowed expenses should lead the Commission to find them unreasonable. In light of recent deflation (see AG Cross Ex. 16; AG/JM Ex. 5.0 at 31-33), the economic pressure facing consumers and local governments, and

the unexceptional nature of this rate case, the 43% increase in legal fees and expenses requested by the Company is simply unacceptable. The Commission should limit the Company's legal fees and expenses to the amount allowed in 2007, or at the most, increase them by 10%.

2. The Service Company Study Cost Is Outrageous And Should Be Disallowed.

In IAWC's last rate case, the Commission expressed concern that IAWC was "doing everything possible to ensure low costs for ratepayers," and it directed IAWC to compare the cost of Service Company services to the costs of such services had they been obtained through competitive bidding on the open market. Docket 07-0507, Order at 30-31 (July 30, 2008). In response, IAWC submitted the testimony of (1) Bernard L. Uffelman, IAWC Ex. 10.00, (2) Mark R. Young, IAWC Ex. 11.00, and (3) John S. Young, IAWC Ex. 12.00 as well as testimony by (4) IAWC President Karla Teasley, IAWC Ex. 1.00 at 15-26 & Ex. 1.04; Ex. 1.00 Supp; and testimony by (5) IAWC witness Edward J. Grubb, IAWC Ex. 5.00 at 2-12; Ex. 5.01-5.03, 5.03 Supp. A "Service Company Study" was prepared by Mr. Uffelman and Mr. Mark Young and submitted as IAWC Exhibit 11.01.

IAWC Exhibit 11.01 contains 22 pages of narrative, a 2 page Appendix with FERC Account Descriptions, and eight schedules showing billing rates and hours worked for various service types.

IAWC President Karla Teasley presented a "Self Provision Study" which addressed corporate governance, customer service centers, and employee benefits, and those services were excluded from the study. Tr. at 362 (Dec. 9, 2009).

Mr. Mark Young only prepared Direct Testimony. Mr. John Young prepared Direct Testimony about the Service Company and Surrebuttal Testimony on an unrelated issue that was later withdrawn. Tr. at 430 (Dec. 9, 2009). Mr. Uffelman submitted direct, rebuttal and surrebuttal testimony, but his rebuttal and surrebuttal testimony addressed municipal witnesses

unrelated to the Service Company Study. See IAWC Ex. 10.00R, 10.00 SR. He appeared for cross examination on the Service Company Study as well as municipal rates issues on one day (December 9).

Mr. Uffelman testified that he was retained to do the Study in January, 2009, and he believed that five or six people prepared the Service Company Study. Tr. at 363, 370 (Dec. 9, 2009). Although he did not know the number of hours it took to complete the Study, he estimated it at 500 hours. Id. at 405. Mr. Uffelman did not exactly recall, but testified that he thought he received “125,000, 150,000 maybe” for the study, and would receive another 50,000, 60,000 something like that,” for his testimony. Id. at 404-405. These amounts would equal \$175,000 to \$210,000 for the Study and for his services. Yet, IAWC has asked for \$422,900 for the 22 page, 8 schedule report.

In the prior rate case, Mr. Uffelman prepared a report entitled “Municipal Rate Study.” Docket 07-0507, Order at 31-44 (July 30, 2008). IAWC requested \$37,000 for that study on its Schedule C-10.1 in that case. AG Cross Ex. 19. In this case, IAWC identified an additional \$187,000 for that study (which should not be recovered in future rates). IAWC has not explained how the cost of the study jumped from \$37,000 to \$224,000, but even assuming that is what IAWC in fact paid, it is significantly less than the \$422,900 IAWC is seeking for the Service Company Study.

The cost for the Service Company Study can also be compared to the cost of service study and demand study submitted in this docket. IAWC is asking \$249,540 for both the demand and the cost of service studies, which together produced hundreds of pages of cost information, analysis and proposed rates as well as testimony. J. Rowe McKinley submitted testimony and exhibits about the demand study. IAWC Ex. 13.00, 13.00R1, 13.00 R2, 13.00 SR; a Report on Capacity Factors by Customer Class, IAWC Ex. 13.01 (April, 2009), a revised Report, IAWC Ex. 13.01 R1 (October 2009). Testimony and exhibits sponsored by Paul Herbert address cost of

service allocations as well as rate design for all customer classes. See IAWC Ex. 9.00, 9.01 (cost of service studies) through 9.10.

It is hard to fathom how the Service Company study, which basically multiplied the number of Service Company hours by hourly rates obtained from hourly rate surveys¹¹ could possibly justify more than \$420,000 from ratepayers. IAWC has not met its burden on proof to justify recovery of this expense, and it should be disallowed. See 220 ILCS 5/9- 201(c) (“the burden of proof to establish the justness and reasonableness of the proposed ... charge ... shall be upon the utility.”). IAWC has not explained why it asked for \$37,000 for the Municipal Study but asked for more than 10 times as much for the Service Company Study, produced by the same consultant, over a relatively short period of time (January, 2009 and filed May 29, 2009). The substance of the work product simply does not justify the huge price tag.

3. The Service Company Study Did Not Conform To The Commission Direction And Consumers Should Not Pay For It.

In Docket 07-0507 the Commission commented on the increase in Service Company fees and directed IAWC to prepare a study showing whether it would be more economical to obtain services through competitive bidding. The Commission said:

Because the Commission questions whether IAWC is doing everything possible to ensure low costs for ratepayers, the Commission directs IAWC to conduct a study comparing the cost of each service obtained from the Service Company to the costs of such services had they been obtained *through competitive bidding on the open market*. As part of the study, IAWC must also provide an analysis of the services provided by the Service Company to all of IAWC's affiliates. The analysis must provide details on the specific services provided to IAWC and how costs are allocated among affiliates of IAWC. IAWC shall include the study in its next rate filing.

Order at 30-31 (emphasis added).

As demonstrated in the Village of Bolingbrook’s “ Motion To Strike The Testimony of

¹¹ Mr. Uffelman testified that he assumed that a non-affiliated provider would bill the same number of hours that AWWSC bills IAWC for the same work, Tr. 375-376, and that the distribution of work among different levels of experience and education would be the same for affiliated and non-affiliated providers. Tr. 378. Effectively, the only variable in the study was the market hourly rate, which was compared to AWWSC’s “fully loaded” rates.

Certain Illinois American Water Company Witnesses, Certain Exhibits, and to Dismiss the Petition,” filed on October 6, 2009 (“Bolingbrook Motion”), and in the Village of Bolingbrook’s Reply, filed on October 30, 2009, the Service Company Study is not based on competitively bids. According to IAWC witness Mark Young, the study is a “comparative study of Service Company cost and market prices for certain services.” IAWC Ex. 11.00 at 15. As the Village of Bolingbrook has pointed out, a comparative cost study is not the same as a report of the result of competitive bidding. Bolingbrook Motion at 3-5.

At the hearing, IAWC President Karla Teasley admitted that “there is some bidding on contract services,” although she was not familiar with municipal competitive bidding requirements. Tr. at 197. Nevertheless, the study she provided in IAWC Ex. 1.02 and the Service Company Study at IAWC Ex. 11.01 did not contain cost information obtained through competitive bidding.

The Village of Bolingbrook’s October 30, 2009 Reply contains relevant language and citation to Illinois law that describes necessity of competitive bidding. Incorporating that argument here without repeating it, the Commission’s directive to check the cost of Service Company services against competitively bid services would enable the comparison of costs while eliminating “favoritism, improvidence, extravagance, fraud and corruption” through competitive bidding. IAWC’s Study did not include these protections.

The People submitted a Response in Support of the Bolingbrook Motion on October 23, 2009, and incorporate the arguments contained in that Response in this Initial Brief. Further, the record shows that the Study is not a proxy for competitive bidding because its structure removed key variables that non-affiliated vendors might modify to reduce their costs and their prices. Mr. Uffelman confirmed that the Service Company and IAWC provided him with the number of hours billed for each service category as well as the distribution of those hours among different levels of education and experience. Tr. 375, 377-378 (Dec. 9, 2009). The study then simply

applied the hourly rates derived from various market surveys. IAWC Ex. 11.01 at 10. The Study did not consider the possibility that a non-affiliated provider could offer to provide the same services for fewer billed hours than the affiliated Service Company, at a lower or different hourly rate, at a different rate structure, with a different distribution of experience and hourly charges, at a fixed fee, or any other number of variables that competitors may devise to obtain business and achieve efficiencies.

Like in the Tennessee-American case cited above, the IAWC Service Company Study was not independent, and is of little if any help to the Commission. It does not assess whether IAWC could obtain the same services through competitive bidding at a lower cost, whether the Service Company uses a reasonable cost allocation methodology, whether IAWC is charged a reasonable amount, whether the services provided are necessary and prudent, and how the growth of Service Company charges could be staunched. See *In re Tennessee American Water Company*, Docket No. 08-00039, Order at 18-22 (January 13, 2009), available at: <http://www.state.tn.us/tra/orders/2008/0800039we.pdf> . The Service Company Study is of no help to the Commission, and certainly does not justify a \$422,900 price tag, paid by the public. The entire cost of the Service Company Study should be removed from the rate case expense.

F. The Gross Revenue Conversion Factor Should Be Correctly Calculated For Each District.

AG/JM witness Ralph Smith calculated the Gross Revenue Conversion Factor that used the specific uncollectible factor for each of IAWC's service districts. This is appropriate because IAWC creates a different revenue requirement for each district, and a direct measurement of this expense results in a more accurate assignment of costs. The gross revenue conversion factor for each district is found at AG/JM Ex. 5.1, Sch. A-1, page 2, and should be used in calculating IAWC's revenue requirement.

IAWC objected to this per district calculation and asserted that the Company uses a

statewide average for uncollectibles. IAWC Ex. 6.00 R2 at 2-3. However, where there is district specific information available, the use of statewide cost (or uncollectible) information is unnecessary and may distort the appropriate assignment of costs to the districts. Arguments about whether uncollectibles should be allocated by customer count, volume, revenues, or other variables are avoided when the uncollectible expense is determined for each district. The Commission should use the district specific uncollectible information available in this docket in preference to statewide information which must then be allocated among the Districts.

In addition to being more accurate for each district, Mr. Smith's uncollectible expense resulted in a lower overall uncollectible factor for purposes of the gross revenue conversion factor. Although the Company used a statewide, 1.2% uncollectible factor, Mr. Smith demonstrated that a more accurate statewide uncollectible factor, based on a district-up analysis, was 1.17%. AG/JM Ex. 5.1, Sch. A-1 page 2, line 10, column F. Accordingly, the Commission should apply the gross revenue conversion factor recommended by AG/JM witness Smith.

G. Commission Should Adopt the IAWC Large Volume Revenue Adjustment to Accurately Measure Test Year Revenues.

IAWC witness Edward Grubb admitted in his Surrebuttal Testimony that the large volume revenues from U.S. Steel needed to be increased to reflect the operations of that plant. IAWC Ex. 5.0 SR at 2. However, Mr. Grubb has offered to return fewer revenues to its test year than is appropriate, given U.S. Steel's recent demand. The adjustment to add large volume revenues recommended by IAWC witness Brian Collins should be adopted in place of IAWC's inadequate adjustment.

IV. The Commission Should Base IAWC's Cost of Capital on A Capital Structure That Includes 3.26% Short Term Debt at the Current Rate and The Return on Common Equity Proposed by CUB Witness Christopher Thomas.

The Commission should reject IAWC's attempt to effectively fund short term debt at the

significantly higher common equity cost. The record is clear that IAWC regularly uses short term debt whenever there is a shortfall in revenues relative to expenses. Tr. at 303 (Dec. 8, 2009). It uses short term debt to fund cash working capital and to provide a bridge when other debt sources are delayed. Id. at 306, 314. In fact, during the course of this docket, IAWC witness Scott Rungren said that at least four different long term debt financings were not issued when expected. Id. at 307. Low cost, short term debt financing gives the Company the flexibility to handle situations where long term debt issuances fail to market, debt becomes due unexpectedly, or falling interest rates make it prudent to time debt issuances. Id. 306-307. Among the debt that was delayed was a \$39 million planned debt, of which only \$14 million was issued on December 4, 2009. The remaining \$25 million was rescheduled to May, 2010, and will be treated as short-term debt until it get reissued as long term debt. Id. at 320 & AG Cross Ex. 14.

Although the amount of short term debt varies over the course of a year, it is unreasonable and unrealistic to assume, as IAWC would have the Commission do, that IAWC will have virtually no short term debt during the 2010 test year. It is already apparent that IAWC will have \$25 million of short term debt pending the May 2010 issuance of long term debt for the remainder of the planned \$39 million debt discussed above. This amount, without regard to other short term debt needs, exceeds the 3.26% of short term debt that AG/JM witness Smith recommends should be included in IAWC's capital structure. (3.26% of rate base of \$612 million = 19.95 million).

It is undisputed that short term debt is the least expensive source of capital. Tr. at 316. Further, if you increase the short term debt in the capital structure, you typically get a lower cost of capital simply on the basis of arithmetic. Tr. at 317. Therefore, the effect of IAWC's "no short term debt" position is to unreasonably increase the cost of capital paid by consumers by inflating the cost of capital by \$2.2 million at CUB witness Thomas's 7.4% cost of equity, and \$3

million using Staff's 1% cost of short term debt and a 10.38% cost of equity. AG/JM Ex. 5.0 at 13-15. Consumers' rates should only include prudent and reasonable costs, and it is neither prudent nor reasonable to pretend that the Company will not need or use *any* short term debt and charge consumers the cost of equity, which is more than 10 times more expensive than short term debt.

The Commission should adopt a capital structure with 3.26% short term debt as shown on AG/JM Ex. 5.1, Sch. D, and the 7.4% cost of equity recommended by CUB witness Christopher Thomas. IAWC witness Rungren testified that the actual cost of short term debt for November, 2009 was 0.3437%. Tr. at 320 (Dec. 8, 2009). This short term debt cost is much lower than the cost of equity. If the equity component of IAWC's capital structure is increased to replace a reasonable portion of short term debt, consumers will pay IAWC's affiliate American Water Capital Corporation, which provides IAWC with both equity and short term financing (id. at 304), the higher equity cost despite the fact that IAWC will only need short term financing for a portion of IAWC's capital needs.

The Commission should adopt a capital structure with 3.26% of short term debt, as recommended by AG/JM witness Ralph Smith. This will assure that IAWC is appropriately compensated for its cost of capital, and that ratepayers do not provide IAWC's affiliate with an equity return for short term debt financing.

V. IAWC's Residential Rate Design Should Be Rejected In Place Of A Rate Design That Moves Fewer Costs To Fixed Charges.

A. IAWC's Proposed Customer Charges Are Excessive, Include Non-Customer Costs, and Should Be Reduced To Allow Customers To Control Their Bills By Controlling Their Usage.

IAWC proposed to increase the customer charges in its four water districts from 32.6% to a high of 56.4%, ranging from \$17.75 to \$15.25 to \$12.25 for Lincoln. However, these large customer charges are not cost based, and should be reduced to a level that reflects the costs

associated with a basic hook up to the system, operations and maintenance expense associated with maintaining the meter and service line and the costs for meter reading, billing and customer service. AG Ex. 2.0 at 5.

As shown by AG witness Scott Rubin, IAWC improperly included additional costs associated overhead and general plant in its customer cost. Mr. Rubin provided a detailed listing of 18 cost categories that are not directly related to connecting a customer to the system, reading the customer's meter and sending the customer a bill, but that IAWC used to justify customer charges as high as \$17.75. AG Ex. 2.0 at 6-7. When inappropriate costs are removed, and assuming that the Commission allows the Company to increase its revenues by the amount requested, the customer charges based on an appropriate calculation of customer costs are as follows:

Rate Area	Present 5/8" Customer Charge	Company Proposed Customer Charge	Maximum Customer Charge Based on Cost
Zone 1	\$13.39	\$17.75	\$13.47
Chicago Metro	\$ 9.75	\$15.25	\$12.75
Lincoln	\$ 7.91	\$12.25	\$11.78
Pekin	\$12.74	\$17.75	\$13.37

Sources: AG Ex. 2.0 at 5 and AG Ex. 6.0 at 10.

Given how close the Zone 1 customer charge is to the properly determined customer cost, no change to the Zone 1 customer charge should be approved, and no 5/8" customer charge should exceed the maximum customer charge based on the cost of service. Assuming that the Commission reduces the revenue increase requested by the Company, the customer charges will also have to be reduced to reflect the lower cost level. AG Ex. 2.0 at 11.

B. IAWC should retain a declining usage block rate for commercial and large residential users in all Districts.

IAWC currently has various rate designs in its Districts, and the Company has proposed steps to make the rates in its Districts more consistent. One of those proposed changes is to

create a residential class with a single rate for usage, which is the current rate structure in the Chicago Metro area. There are significant problems with this proposal that can be avoided by structuring IAWC's usage blocks to assure that only very large users, who should be less costly to serve due to their large demand, receive the benefit of a declining block.

In all IAWC districts except Chicago Metro, the classification of a customer as residential or commercial is currently irrelevant to the customer's usage rate. If a large apartment building is master-metered, it pays the same block rate as a commercial business, such as a car wash. As a result, precise customer classification has not been necessary in most of Illinois. AG Ex. 2.0 at 18. However, under IAWC's proposal to eliminate the declining usage block rate for residential customers but not for commercial customers, residents of apartment buildings, condominium complexes, and other multi-unit buildings in all areas outside Chicago Metro will be exposed to significant increases. AG witness Rubin analyzed the bill impact of this change on residential customers using 1.5 inch meters, and showed that the bill increases ranged from 28 to 79%. If the declining block were retained in those areas for all customers regardless of classification, no customer's bill would increase by more than 30%. AG Ex. 2.0 at 19-20 & 2.04. Further, Mr. Rubin's analysis in AG Exhibit 6.03 showed that IAWC includes at least 130 customers classified as residential that used 115 ccf per month on average – an amount at least 20 times used by the typical residential customer. AG Ex. 6.0 at 13 & AG Ex. 6.03. These customers have usage characteristics that are so different from the typical residential customers that it is unreasonable to change their rates to match the rates that apply to single-family residences.

The retention of a residential (or non-class based) declining block usage rate does not promote wasteful use of water. Residential customers simply do not use 30 ccf in a month. Mr. Rubin's analysis of 704,852 residential bills shows that 99.3% of customers used less than 30 ccf in any given month. AG Ex. 2.0 at 15. IAWC's first block is large enough to eliminate any residential anti-conservation effect. *Id.* at 21.

Elimination of the declining usage block for residential customers outside the Chicago Metro area, while retaining the declining usage block for other customer classes, is bad policy not only because of the potential confusion and possible errors resulting from the need to classify each meter according to the customer's type of use (residential or other). Usage rates should vary with the size of the customer and not be dependent on classification. AG Ex. 2.0 at 17. It is "generally less costly for a water utility to sell one million gallons per month to a single customer than to sell that same one million gallons to 200 smaller customers because the cost of distribution tends to be less for very large customers. *Id.* at 14. A properly sized declining block usage rate structure will recognize these economies of scale while retaining the conservation message for smaller residential customers who do not use enough water in a given month to trigger the declining block.

C. IAWC's Public Fire Charges in Chicago Metro Should Increase With The Size of The Customer's Meter in the Same Manner As In IAWC's Other Districts.

AG witness Scott Rubin testified that in the Chicago Metro area, unlike in IAWC's other service areas, the fire protection surcharge is the same, regardless of the size of the meter or the number of meters on the bill. Mr. Rubin recommended that the Chicago Metro public fire charge be modified to reflect the same methodology used in other IAWC districts, and IAWC agreed to this proposal. See AG Ex. 6.0 at 3-4. To the extent that the revenue increase allowed in this docket is less than requested by IAWC, the public fire charges should be reduced proportionally. AG Ex. 2.0 at 23.

VI. IAWC's Sewer Treatment Costs and Charges Are So Excessive As To Require An Independent Study Of Alternatives To Continued Cost and Rate Escalation.

IAWC's cost of service study in this docket revealed that the costs for wastewater treatment are significantly higher than IAWC's rates. The current wastewater treatment rate for about 5,000 gallons (7 ccf) is currently \$28.43. However, to recover half of the cost of service, wastewater treatment rates will have to increase to \$51.40, an 80% increase. AG Ex. 2.0 at 24. To recover the entire cost, the typical customer's bill just for wastewater treatment would be in excess of \$70 per month, to which would be added wastewater collection (\$17.52) and water service. *Id.*

This cost is excessive, and consumers cannot be expected to shoulder costs like these, particularly in light of the lower rates charged by other wastewater treatment providers. For example, Mount Prospect residents Avis Gibbons and Robert Boros pay the equivalent of \$20.64 and \$16.06 per month to the Metropolitan Water Reclamation District for wastewater treatment. AG Ex. 3.0 at 3 & AG Ex. 4.0 at 3. In three IAWC areas, consumers pay a purchased wastewater treatment charge on their IAWC bills. Residential customers pay a third party for wastewater treatment \$17.23 per month in the Rollins area, as of April 1, 2009; \$21.28 in the Valley View area as of April 1, 2009; and \$44.85 in the Country Club area as of October 1, 2009.¹²

IAWC serves fewer than 9,000 treatment and collection customers. In four of the nine areas, it serves fewer than 100 customers, but in Homer Glen it serves 7,323 customers. AG Cross Ex. 17. Homer Glen Trustee Mary Niemiec expressed concern that "unreasonable high

¹² See Ill.C.C. No. 5, 9th Revised Information Sheet 4 (Supplemental to ILL.C.C. No. 5, Sheet Nos. 60 through 64) Purchased Sewage Treatment Surcharge Rider Information Sheet for Rollins; Ill.C.C. No. 5, 8th Revised Information Sheet 2, Purchased Sewage Treatment Surcharge Rider Information Sheet for Valley View; Ill.C.C. No. 5, 12th Revised Information Sheet No. 1 (Supplemental to ILL.C.C. No. 5, Sheet Nos. 60 through 64) Purchased Sewage Treatment Surcharge Rider Information Sheet for Country Club. Tariff sheets attached.

water and sewer rates will drive builders and homeowners away from Homer Glen, creating a cycle where the remaining captive customers of IAWC will pay even higher rates.” HG Ex. 2.0 at 4. She testified that the proposed sewer rate is 210% to 518% higher than that of surrounding communities. Id. at 5. Homer Glen witness Aaron Fundich related the wastewater collection and treatment charges of two towns near Homer Glen, where IAWC provides wastewater treatment. In 2009, Mokena charges \$3.60 per 1,000 for collection and treatment, equaling \$18.00 for 5,000 gallons of water; New Lenox charges \$3.76 per 1,000 for collection and treatment, equaling \$18.80 for 5,000 gallons of water. HG Ex. 4.0 at 10. Ms. Niemiec noted that the sewer charges for Joliet, Manhattan, and Plainfield are \$2.04 per ccf (equal to \$1.525 per 1,000 gallons). By contrast, IAWC is requesting a \$51.40 residential wastewater treatment charge plus a \$17.52 wastewater collection charge, equaling \$68.92 – about three times more than charged by other providers. And these charges only cover half of IAWC’s wastewater treatment costs.

In light of these wild disparities in cost and rates, AG witness Rubin recommended that the Commission conduct an *independent* audit, at the Company’s expense, of IAWC’s wastewater treatment operations to determine whether it is in the public interest to withdraw IAWC’s certificate to provide wastewater treatment services. The Commission study should include an assessment of whether there are public or other wastewater treatment operators that can provide the service to IAWC water customers at a more reasonable and comparable cost.

Due to the huge increases in the wastewater treatment rate implied by IAWC’s cost of service, Mr. Rubin further recommends that wastewater treatment rates increase by no more than 50% -- rather than the 80% proposed by IAWC.

VII. Conclusion

For the foregoing reasons, the People of the State of Illinois request that the Commission make the adjustments and disallowances discussed above, make the rate design changes recommended above, and order IAWC to fund an independent, Commission study of its

wastewater treatment facilities to determine whether wastewater treatment can be provided by another provider more economically.

Respectfully submitted,

People of the State of Illinois
Lisa Madigan, Attorney General

By: _____
Susan L. Satter, Sr Assistant Attorney General
Public Utilities Bureau
100 W. Randolph St., 11th Fl.
Chicago, Illinois 60601
Telephone: (312) 814-1104
Facsimile: (312) 814-3212
E-mail: ssatter@atg.state.il.us

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